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# Accounting Periods and Methods

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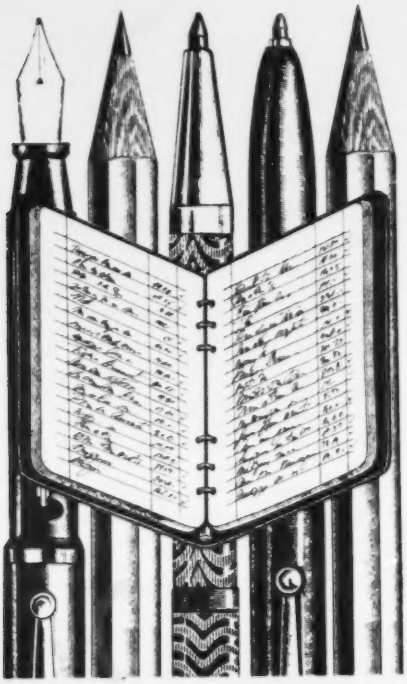
For use in preparing
**1980 Returns**



You can get the tax forms and publications referred to in this publication by writing to the IRS Forms Distribution Center listed in your Form 1040 or 1040A Instructions. Or, you can call the Tax Information number in the phone book listed under "United States Government, Internal Revenue Service."

## Introduction

Taxable income is figured by using a fixed accounting period and a set of rules to decide when and how to report income and deductions.

An accounting method is the set of rules that you use to decide when and how to record income and expenses in your books, and how to prepare a profit and loss statement for your accounting period.

You must use the same method from year to year and figure your taxable income following the accounting method you use to keep your books, if that method clearly shows your income. Any accounting method that shows the consistent use of generally accepted accounting principles in keeping with practices in your trade or business may be considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all deductions are treated the same from year to year.

However, for certain items, such as installment sales, long-term contracts, research and experimental expenditures, and depreciation you may be permitted to use a method other than the general accounting method you use for your books and records.

## Accounting Methods

No single method of accounting is required of all taxpayers. Each must use a system that clearly shows income and deductions. This means that in addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

Among the necessary records you must keep to support the entries in your books are:

1) Inventory records in businesses in which the production, purchase or sale of merchandise is an income-producing factor; and
2) Disbursement records to properly classify all expenditures as a current expense, a capital expenditure, or an improvement.

If you do not have an accounting method or if the method you use does not clearly show your income, your income will be figured under the method that, in the opinion of the Internal Revenue Service, clearly shows your income.

**Methods you may use.** Subject to the preceding rules, you may figure your taxable income under any of the following accounting methods;

1) Cash method; or
2) Accrual method; or
3) Special methods such as those for installment sales and long-term contracts; or
4) Any other method that clearly shows income, including combinations of the preceding methods.

### The Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. If you keep no books or records it is the method you usually must use.

**Income.** With the cash method you include in your gross income all items of income you ***actually or constructively receive*** during the year. Property and services you receive must be included in your income at their fair market value.

You have ***constructive receipt*** of income when an amount is credited to your account or made available to you without restriction as to the time or manner of payment. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received that income when your agent receives it.

***Example 1.*** Interest that is credited to your bank account in December 1980 must be included in your gross income for 1980 and not for 1981 when it is withdrawn or entered in your passbook.

***Example 2.*** If you had interest coupons that matured and were payable in 1980, but you do not cash them until 1981, you must include them in income for 1980. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

You cannot hold property from one tax year to another to avoid paying the tax on the income, because you must report the income in the year the property is made available to you without restriction.

**Expenses.** Usually, you must deduct expenses in the tax year in which you actually pay them. However, you may get special treatment for expenses that you pay in advance.

***Expenses you pay in advance*** can be deducted only in the year to which they apply.

***Example.*** If you are a calendar year taxpayer and you pay $3,000 for an insurance policy that is effective on July 3, 1980, for a 3-year period, you may deduct $500 in 1980, $1,000 in 1981 and 1982, and $500 in 1983.

### The Accrual Method

The purpose of the accrual method of accounting is to match your income and your expenses in the correct year.

**Income.** Under the accrual method, all items of income are included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened and you must be able to figure the amount with reasonable accuracy.

***Example.*** You are a calendar year taxpayer. You sold a radio on November 28, 1980. You billed the customer 3 days later but you did not receive payment until February 1981. You must include the amount of the sale in your income for 1980 because you earned the income in 1980.

**Advance payments for services.** If you use the accrual method of accounting and you receive advance payments for services to be performed by the end of the next tax year under an agreement, you can postpone including the advance payments in income until you earn them. However, you may not postpone including them beyond the year after the year you receive them.

You may postpone reporting in income the advance payment you receive under service agreements (including agreements providing for incidental replacement of parts or materials) that are for property that you offer to sell, lease, build, install, or construct without service agreements in the normal course of business.

You may not postpone reporting in income amounts that you receive under guarantee or warranty or for prepaid rent or prepaid interest. Prepaid rent does not include payments for use of rooms or other space when significant services are also provided for the occupant. You provide significant services when you supply space in hotels, boarding houses, tourist homes, motor courts, motels or apartment houses that furnish hotel services.

Usually you may not postpone including advance payments if, under the agreement:

1) You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or
2) You are to perform any part of the services at any unspecified future date which may be after the end of the tax year immediately following the year you receive the advance payments.

Any advance payment that you include in gross receipts in the tax year you receive the payment may not be less than the amount of the payment you include as gross receipts in gross income in your books and records and all your reports (including consolidated financial statements) to shareholders, partners, other proprietors or benficiaries, and for credit purposes.

If you want to defer income as previously described, you must first have the consent of the Internal Revenue Service as discussed later under *Changing Your Method of Accounting*.

In each of the examples that follow you use the calendar year and the accrual method of accounting.

***Example 1.*** You manufacture, sell, and service television sets. In 1980 you received payment for a television set you sold with a one-year contingent service contract. You may not postpone including these payments in income if you offer the television sets for sale without the contingent service contracts in the normal course of your business.

***Example 2.*** You are in the television repair business. In 1980, you received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were sold by an unrelated party. You may include the payments in gross income as you earn them by performing the services.

If for any reason you do not perform part of the services by the end of the following tax year (1981), you must include in gross income for 1981 the amount of the advance payments that are for the unperformed services.

***Example 3.*** You own a dance studio. On November 3, 1980, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons in 1980. Under this method of including advance payments, you must include one-sixth of the payment in income for 1980, and five-sixths of the payment in 1981, even if you cannot give all the lessons by the end of 1981.

**Advance payments for future sales or other dispositions of goods.** If you use the accrual method of accounting or a long-term contract method of accounting, advance payments for future sales or other dispositions of goods that you receive are included in your income under special rules. Under these rules, advance payments include advances on future sales of goods you held primarily for sale to your customers in the ordinary course of your trade or business. They also include payments receive under agreements for building, installing, constructing, or manufacturing items, if you do not complete the agreement in the tax year.

If the advance payments are for contracts involving both sale and service of goods it may be necessary to treat them as two agreements. An agreement also means a gift certificate that can be redeemed for goods. Amounts that are due and payable are treated as received.

***Inclusion in income.*** You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them. Under an ***alternative method*** you may include them in income in the ***earlier*** tax year in which:

1) You include the advance payments in gross receipts under the method of accounting that you use for tax purposes; or
2) You include any part of the advance payments in any of your financial reports under the method of accounting used for those reports.

Your financial reports include your reports to shareholders, partners, beneficiaries, other proprietors, for credit purposes, and for consolidated financial statements.

***Example 1.*** You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this method of accounting for both tax and reporting purposes. Therefore, you must include advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods.

***Example 2.*** You are a calendar year taxpayer who manufactures household furniture. You use the accrual method of accounting. Under your method of accounting you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted. In 1979, you receive an advance payment of $8,000 from a customer for an order of furniture to be manufactured for a total price of $20,000. You shipped the furniture to your customer in December 1979, but it was not delivered and accepted until January 1980. You must include the entire $8,000 advance payment in your gross income for tax purposes in 1979. You include the remaining $12,000 of the contract price in your gross income, for tax purposes, in 1980.

***Long-term contracts.*** If you account for advance payments for tax purposes by using a long-term contract method of accounting (the percentage of completion or completed contract method), you include advance payments in gross income by following your method of accounting regardless of the financial reporting requirement that was discussed previously. This also applies if you account for advance payments for a long-term contract under an accrual method of accounting under which the income is accrued when, and the costs are accumulated until, the item is shipped, delivered, or accepted. A further discussion of the long-term contract method of reporting income appears later.

***Exception for inventoriable goods.*** If you receive advance payments under an agreement for the sale of goods that are properly includible in your inventory or under an agreement, such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of sale, you may be able to postpone including the advance payments in income in the year of receipt. The postponement period for advance payments on inventoriable goods may extend only until the end of the second tax year following the end of a tax year in which you received an advance payment and met the following conditions:

1) You must account for advance payments under the alternative method as discussed earlier in *Inclusion in income;* and
2) You must have received substantial advance payments (discussed later) on the agreement; and
3) You must have on hand or available to you through your normal source of supply in that year enough substantially similar goods to satisfy the agreement.

If you meet these conditions at the end of a tax year then, at the end of the second tax year after the year in which you received substantial advance payments, you must include in income all advance payments you have received to date that have not already been included in income under your accrual method of accounting for advance payments. Also at the end of this second year you must deduct all actual or estimated inventoriable costs of goods necessary to satsify the contract. Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account when the goods are delivered. After this period any more advance pay-

ments received on this contract are reported in income in the year received because no further deferral is allowable on this contract.

Under an agreement for a future sale, ***substantial advance payments*** are considered as received by the end of a tax year if the total advance payments received during the current and preceding tax years, are equal or more than the total costs and expenditures reasonably estimated to be includible in inventory because of the agreement.

***Example.*** You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method as discussed earlier under *Inclusion in income*. In 1977 you entered into a contract for the sale of goods that are properly includible in your inventory. The total contract price is $50,000 and you estimate that your total inventoriable costs for the goods will be $25,000. You received the following advance payments under the contract:

| | |
|---|---|
| 1977 | $17,500 |
| 1978 | $10,000 |
| 1979 | $ 7,500 |
| 1980 | $ 5,000 |
| 1981 | $ 5,000 |
| 1982 | $ 5,000 |

Your customer asked you to deliver the goods in 1983. In your 1978 closing inventory you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of 1978 were more than the inventoriable costs you estimated you would have, the payments are substantial advance payments. All payments you receive by the end of 1980, the second tax year following the tax year in which substantial advance payments are received, are included in income for 1980. Therefore, you must include $40,000 in income for 1980, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payment you receive that year. Any difference between the estimated costs and the costs you actually have in satisfying the contract is to be taken into account in 1983, when you deliver the goods.

***Information schedule.*** If you use this alternative method of treating advance payments for future sales of goods, you must attach to your income tax return for each tax year, a statement that shows the following information:

1) Total advance payments you received in the current tax year; and
2) Total advance payments you received in earlier tax years that you have not included in income before the current tax year; and
3) Total payments you received in earlier tax years that you have included in income for the current tax year.

To adopt this method you must first get the consent of the Internal Revenue Service.

**Amount of compensation accruable.** If you use the accrual method of accounting and contract to perform services for a basic monthly rate, but, as a matter of convenience, you agree to receive monthly payments at a lower rate and the difference between the basic rate and the amount paid to you monthly, when you complete your services, you must include the basic rate in your income as it accrues.

**Expenses.** If you are in a business that uses the accrual method of accounting, you deduct business expenses when you have them, whether or not you pay them in the same year. All events that set the amount of the liability must have happened, and you must be able to figure the amount of the expense with reasonable accuracy.

***Example.*** You are a calendar year taxpayer and in December 1980, you buy office supplies. You are billed in January 1981, and you pay in the same month. The expense is deductible in 1980 because all of the events that set the amount of the liability happened in that year.

**Inventories** are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are necessary to show income correctly, only the accural method of accounting may be used for the purchases and sales. Inventories are discussed later.

**Transactions between related taxpayers.** If you use the accrual method you will not be allowed to take a deduction for unpaid business expenses or interest you owe to a related taxpayer unless the related taxpayer uses the accrual method of accounting for those items of income; or uses the cash method and the unpaid expenses or interest are received or constructively received by that related taxpayer within 2½ months after the close of your tax year. If the 2½ month period ends on a Saturday, Sunday, or legal holiday, the period will be treated as ending on the next day that is not a Saturday, Sunday, or legal holiday. See Publication 535, *Business Expenses and Operating Losses*, for more information on related taxpayers.

### A Combination of Methods

You may use any combination of the preceding accounting methods if the combination clearly shows income and is used consistently. Such a combination is known as a hybrid method. However, the treatment of certain items of income and expense must comply with the following specific requirements.

If you are in business and you use an accrual method for figuring gross profit from purchases and sales, you may use the cash method for figuring all other items of income and expense. However, if you use the cash method for figuring gross income from your business, you must use the cash method for figuring business expenses. If you use an accrual method for figuring business expenses, you must use an accrual method for figuring all items that affect your gross income and for figuring gross profit from your business.

**Business and personal items** may be accounted for under different accounting methods. Thus, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

**If you own more than one business,** you may use a different accounting method for each separate business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business, but you must use the accrual method for the manufacturing business.

If you do not keep a complete and separate set of books and records for a business, that business is not separate.

### Special Methods

You may use a special method of accounting for reporting income and expenses for *Long-Term Contracts*, discussed later in this publication. Other special accounting methods are discussed in other publications that you may get from most Internal Revenue offices. These publications discuss reporting installment sales by dealers in personal property (Publication 512); reporting casual deferred payment sales of real and personal property (Publication 537); treating certain business expenditures as either capital items or current business expenses (Publication 535); methods of depreciation (Publication 534); and amortization and depletion (Publication 535).

### Other Methods of Accounting

You may be authorized to continue using a method of accounting that you have been using consistently, even though it is ***not*** one of those described previously, if, in the opinion of the Internal Revenue Service, it clearly shows your income.

## Inventories

The most common kinds of inventories are:

1) Merchandise or stock in trade.
2) Raw materials.
3) Work in process.
4) Finished products.
5) Supplies (that will become a part of the item intended for sale).

To arrive at a dollar amount for your inventory you need a method for ***identifying,*** and a basis for ***valuing*** the items in your inventory.

Inventory valuation rules cannot be the same for all kinds of businesses but the method you use must be within the scope of the best accounting practice used for similar businesses and clearly show income. To

clearly show income, you must use the same inventory practice from year to year.

## Identifying Inventory Items

To value your inventory you must know what items to include and what items to exclude from the inventory.

**Inventories include** all your finished or partly finished goods and raw materials and supplies that will become a part of the merchandise you intend to sell.

***Merchandise*** should be included in your inventory only if you have title to it. You should include merchandise you purchase in inventory, if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory should also include goods under contract for sale that you have not yet segregated and applied to the contract, goods out on consignment, and goods that are in display rooms, merchandise mart rooms or booths that are located away from your place of business.

Other methods of accounting for inventory may be acceptable if they follow generally accepted accounting principles and are consistently used from year to year. For example, if you are a manufacturer, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. These goods are not included in your inventory.

***Containers*** such as kegs, bottles, and cases, whether or not on hand and whether or not returnable, should be included in your inventory if title to them has not passed to a buyer of the contents. If title has passed to a buyer, you should exclude the containers from your inventory. Under certain circumstances, some containers may be depreciated. See Publication 534, *Depreciation.*

***C.O.D. mail sales.*** If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Merchandise shipped in this way is excluded from your sales and included in your closing inventory until the buyer pays for it.

**Exclude from your inventory** all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future deliverty if you do not yet have title to them.

***Assets such as land,*** buildings, and equipment, used in your business, as well as notes and accounts receivable, and similar assets, should not be included in your inventory. Also, real estate held for sale by a ***real estate dealer*** in the ordinary course of business is not included in inventory.

***Expenses of operating your business*** other than those that apply to your cost of goods held for sale are deducted from your gross income. They are not added to your inventory value.

Shipping or selling expenses, such as ***freight-out, express out, and cartage out*** are deducted as other business expenses. They are not deducted as a part of the cost of goods sold.

***Supplies on hand*** at the end of the year that do not physically become part of goods you have manufactured and intend to sell are not included in your inventory. The cost of these supplies are deducted as business expenses to the extent they are actually used during the tax year, if you have not already deducted their cost in a prior year.

## Cost Identification

The ***The specific identification method*** is used to identify items in an inventory with their costs by matching the goods with their invoices (less appropriate discounts) to find the cost of each inventoried item.

If there is no specific identification of items with their costs, an assumption must be made to decide which items were sold and which remain in inventory. This identification may be made by either the first-in first-out method, or the last-in first-out method.

The ***first-in first-out (FIFO) method*** assumes that the items you purchased or produced first are the first items you sold, consumed or otherwise disposed of.

The items in inventory at the end of the tax year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that they cannot be identified with specific invoices, you must use the FIFO method to value these items, unless you elect to adopt the last-in first-out (LIFO) method.

The ***last-in first-out (LIFO) method*** assumes that the items of inventory that you purchased last are sold or removed from inventory first. Thus, items included in your ending inventory are considered to be those from the opening inventory plus those items acquired in the LIFO order. If you use this method, you must value your inventory at ***cost*** regardless of its market value.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO will produce a smaller cost of goods sold and a higher closing inventory. Under FIFO the reverse will be true.

To adopt that LIFO method, you are required to file Form 970. *Application to Use LIFO Inventory Method,* according to its instructions, or a statement that has all the information required in Form 970. You must file the statement with your timely filed tax return for the year in which you first use LIFO.

The following example shows the results of figuring the cost of goods sold under the FIFO method and under the LIFO method. Because there are very complex rules involved in using the LIFO method that are not discussed in this publication, you may want to consult your District Director.

***Example.*** In tax year 1980 you have an opening inventory of 1,000 units of an item. Your inventory is made up of 500 units purchased in 1978 at $1.00 a unit and 500 units purchased in 1979 at $1.50 a unit. In 1980 you purchased an additional 500 units—200 units at $2.00 a unit in February and 300 units at $3.00 a unit in July.

By the close of the tax year in 1980, you sold 1250 units leaving a closing inventory of 250 units.

Cost of Goods Sold Under FIFO

| | | |
|---|---|---|
| Opening Inventory | | |
| 500 units @$1.00 | $500 | |
| 500 units @$1.50 | 750 | $1,250 |
| Plus: | | |
| Goods purchased during the year | | |
| 200 units @$2.00 | $400 | |
| 300 units @$3.00 | 900 | 1,300 |
| Cost of goods available for sale | | $2,550 |
| Minus | | |
| Closing inventory (1500 less 1250 = 250) | | |
| 250 units @$3.00 (the last 250 units purchased remaining in inventory) | | 750 |
| **Cost of goods sold** | | $1,800 |

Cost of Goods Sold Under LIFO

| | | |
|---|---|---|
| Opening Inventory (adjusted to average cost) | | |
| 1000 units @$1.25 | | $1,250.00 |
| Plus: | | |
| Goods purchased during year | | |
| 200 units @$2.00 | $400.00 | |
| 300 units @$3.00 | 900.00 | 1,300.00 |
| Cost of goods available for sale | | $2,550.00 |
| Minus: | | |
| Closing inventory 250 units (units of opening inventory remain in inventory) @$1.25 (average cost per unit). | | 312.50 |
| **Cost of goods sold** | | $2,237.50 |

## Valuing Your Inventory

Since valuing the items in your inventory is a major factor in figuring your taxable income, the way you value your inventory is very important. These are two common ways to value your inventory if you use the FIFO method: cost; and the lower of cost or market.

For a new business using FIFO you may use either the cost method or the lower of cost or market method to value your inventory. You must use the same method to value your entire inventory, and you may not change to another method without the permission of the Internal Revenue Service.

There are several pricing methods that are recognized for tax purposes which you may use to figure the correct cost basis of your inventory. The dollar value that results is the cost basis of your inventory.

**Specific cost identification method.** The cost of merchandise you purchase during the year is usually invoice price, less appropriate dis-

counts. If you use the specific cost identification method to figure the inventory value of merchandise, materials or supplies, cost means:

1) For goods on hand at the beginning of the tax year, the inventory price of those goods, and
2) For goods purchased during the tax year, the invoice price less appropriate discounts.

You may or may not deduct cash discounts at your option, but you must treat them the same way from year to year. If you do not deduct the cash discounts you must include them in your business income. Transportation or other necessary charges you have in acquiring goods are added to the net invoice price.

**Full absorption method.** If you are engaged in manufacturing or production, you must use the full absorption method. You must take both direct and indirect production costs into account when you figure your inventory costs.

***Direct production costs*** usually are costs necessary for production or manufacturing operations or processes and are part of the cost of either direct material or direct labor.

Direct material costs include the cost of the materials that become an integral part of a product and the materials that are used in the ordinary course of manufacturing. They can be identified with particular units or groups of units of the product.

Direct labor costs include the cost of labor which can be associated with particular units or groups of units of a specific product. This includes such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments under a wage continuation plan which provides payments instead of wages for a period during which an employee is absent from work because of personal injuries or sickness), shift differential and payroll taxes. Payments to a supplemental unemployment benefits plan paid or incurred on behalf of employees engaged in direct labor are also included.

***General rule for indirect costs.*** The indirect costs that are part of inventory costs (regardless of their treatment in your financial statements) include: repairs, maintenance, utilities, rent, indirect labor and production supervisory wages, indirect materials, tools and equipment (not capitalized), and quality control costs. These costs must be included in inventory costs to the extent that they are necessary for the production process.

Costs that are not required to be included in your inventory costs (regardless of their treatment on your financial statements) include:

1) Losses under section 165 of the Internal Revenue Code; and
2) Percentage depletion that is more than cost depletion; and
3) Depreciation and amortization reported for federal income tax purposes that are more than you reported in your financial reports; and
4) Pension contributions for past service costs; and
5) Officers' salaries and administrative expenses, which are necessary for your business operations as a whole, rather than for production operations; and
6) Research and experimental expenses; and
7) Interest expense; and
8) Expenses for marketing, advertising, selling, and distribution.

***Other indirect costs may or may not be included as inventory cost.*** Inclusion or exclusion of these costs from the amount of inventory costs for your financial reports controls whether these costs must be included or excluded from your inventory costs for tax purposes. Your financial statements must be prepared according to generally accepted accounting principles. These costs are:

1) Taxes otherwise allowable as a deduction (other than state, local, and foreign income taxes) on assets necessary for production operations; and
2) Depreciation you reported in financial reports and cost depletion on assets necessary for production operations; and
3) Pension and profit-sharing contributions you made that represent current service costs otherwise allowable as a deduction, and other employee benefits otherwise deductible (such as workmen's compensation, wage continuation plan payments, premiums on life and health insurance, and miscellaneous benefits provided for safety, medical treatment, cafeteria, recreational facilities and membership dues) for labor necessary for production or manufacturing operations or processes; and
4) Costs caused by strikes, rework labor, scrap, spoilage, factory administrative costs, officers' salaries, and insurance, necessary for production or manufacturing operations or processes.

***Exception to general rule for indirect production costs.*** If you use a different method of accounting for production costs in your financial reports than you use for tax purposes, you should use the following rules instead of the rules explained earlier in *General rule for indirect costs.*

Indirect costs that are part of inventory costs include repairs, maintenance, utilities, rent, indirect labor and production supervisory wages, indirect materials, tools and equipment (not capitalized), and quality control costs.

You must also include the following expenses in inventory costs:

1) Taxes otherwise allowable as a deduction (other than state, local, and foreign income taxes); and
2) Depreciation and amortization reported for financial purposes; and
3) Cost depletion; and
4) Administrative costs of production (not including selling costs or return on capital); and
5) Officers' salaries necessary for production or manufacturing operations or processes; and
6) Insurance costs necessary for production or manufacturing operations or processes.

These costs must be included to the extent that they are necessary for the production process.

Under this exception to the general rule, there are only two categories of indirect costs: the indirect costs that must be included in the computation of inventory costs; and those that may be excluded. Indirect costs not specified may be excluded.

***Method of dividing indirect production costs.*** Indirect production costs that are required to be included in your computation of inventory costs must be divided among the goods you manufactured during the year (including goods in your ending inventory) by a method which fairly divides the costs among the items produced. Acceptable methods for doing this include the manufacturing burden rate method and the standard costs method. You can also use the practical capacity concept with either the manufacturing burden rate or a standard cost method.

**Cost or market method.** Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. Thus, if at the end of your tax year you had the following items on hand, the value of closing inventory would be $600.

| Items | Cost | Market | Whichever is lower |
|---|---|---|---|
| R | $300 | $500 | $300 |
| S | 200 | 100 | 100 |
| T | 450 | 200 | 200 |
| **Totals** | $950 | $800 | $600 |

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost ($950) and at market ($800) and use the lower of the two figures. If you use the cost basis, the value of your closing inventory would be $950.

***Market value,*** under ordinary circumstances and for normal goods, means the usual bid price at the date of your inventory. This price is based on the volume of merchandise you usually buy. Thus, if you buy items in small lots at $10 an item and a competitor buys identical items in larger lots at $8.50 an item, your usual market price will be higher than your competitor's.

The lower of cost or market rule applies to goods purchased and on hand, and to basic elements of cost (materials, labor and overhead) of goods in process of manufacture and finished goods on hand. It does not apply to goods on hand or in process of manufacture for delivery at fixed prices on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer). These goods must be inventoried at cost.

***Lower than market.*** When, in the regular course of business, you have offered merchandise for sale at prices lower than market

(as defined earlier), the inventory may be valued at these prices less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable.

***If no market exists,*** or if quotations are given without reference to actual conditions because of an inactive market, you must use whatever evidence of a fair market price is available, at the dates nearest your inventory date. This evidence could include specific purchases or sales you or others made in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments.

***Unsalable goods*** are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots or other similar causes including second hand goods taken in exchange. You should value these goods at selling prices minus direct costs of disposition no matter what basis you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they must be valued on a reasonable basis, considering the usability and condition of the goods. Do not value them at less than scrap value.

**Perpetual or book inventories.** Perpetual or book inventories that are kept by following sound accounting practices are acceptable for figuring the cost of goods on hand. Inventory accounts, however, must be charged with the actual cost of goods purchased or produced, and credited with the value of goods used, transferred, or sold. Credits must be figured on the basis of the actual cost of goods acquired during the year and the inventory value at the beginning of the year.

***Physical inventories*** must be taken at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

**Practices not approved.** The following are some of the inventory practices that are not recognized for tax purposes:

1) Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory; or
2) Taking work in process or other parts of your inventory at a nominal price or less than its full value; or
3) Omitting part of your stock on hand; or
4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock; or
5) Including stock in transit, shipped either to or by you, the title to which you do not hold; or
6) Dividing indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method); or
7) Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

**Choosing your method.** New businesses may use any inventory method and basis explained previously if the method and basis apply to the business and clearly show income. You may usually show you are choosing a method and basis for inventories by figuring your income under that method and basis in the first return you file for the period in which the business begins.

***To change your inventory method or basis,*** you must follow the rules explained later under *Changing Your Method of Accounting.*

**Gains and losses.** Damage from fire or other casualty, or theft of items included in inventory, may result in a casualty or theft loss. See Publication 547, *Tax Information on Disasters, Casualties, and Thefts.* You show any loss from casualty or theft in the value of your closing inventory.

***Sale of entire inventory.*** You must include the total amount you receive from the sale of your entire inventory on your return as ordinary income.

# Special Classes of Business

## Dealers in Securities

If you are a dealer in securities who regularly inventories the unsold securities you have on hand, either—

1) At cost; or
2) At cost or market, whichever is lower; or
3) At market value—

you may make your return on the basis on which you keep your accounts, if you describe your method on your return. All securities must be inventoried by the same method and that method must be used for later years unless another method is authorized by the Internal Revenue Service.

**Limited to cost basis.** If you are a securities dealer and in your books of account you separately figure the gain or loss from the sale of various lots of securities sold on a basis of the cost of each lot, your basis for inventorying securities is the cost basis.

**Who is a dealer?** A dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in buying securities and reselling them to customers for gain or a profit. The securities inventoried may not include those held for investment.

A securities dealer must clearly identify, by records, securities that are held for investment, as distinct from those held for resale. The securities should be identified by serial number, lot number, or other identifying symbol.

**You are not a securities dealer** if you buy and sell or hold securities for investment or speculation only. If does not matter if the buying or selling is treated as carrying on a trade or business. If you do not qualify as a dealer you may not inventory your securities. You must identify the cost of each security purchased, including purchase costs and when you sell a security, you must identify the stock that is sold.

## Miners and Manufacturers

Miners and manufacturers who use a single process or uniform series of processes, to get a product of two or more kinds, sizes, or grades with a similar unit cost may use the cost related to each kind, size, or grade of product as a basis for pricing inventories if the allocation conforms to a recognized trade practice and absorbs the total cost of production. How you divide the total cost must bear a reasonable relationship to the respective selling values of the different kinds, sizes, or grades of product.

In the ***lumber industry,*** for example, products of more than one grade are produced by a common operation, and the cost of any one grade is more or less arbitrary. In the ***packing industry,*** byproducts such as hides, wool, and lard are usually credited at market or selling prices against the cost of fresh meats. You may allocate to a particular grade of product a cost by using the following method:

1) Divide the total selling price of a particular grade of product produced by the total selling price of all grades produced; then
2) Multiply the result by the total cost of production.

To use this method you must first get the consent of the Internal Revenue Service.

## Farmers

A farmer using an accrual method of accounting must use inventories to figure gross income. In addition to the usual methods of valuing inventory, a farmer may use the farm price method (market price less estimated direct cost of disposition) or the unit livestock price method for livestock. See Publication 225, *Farmer's Tax Guide,* for more information.

## Retail Merchants

Retail merchants who use the ***retail method*** of pricing inventories may figure their tax on that basis. On a constant or rising market, this method gives a result approximating cost, but on a falling market, it may result in a reduction to cost or market, whichever is lower.

***To use this method*** on your income tax return you must:

1) State that you are using the method on the return; and
2) Keep accurate accounts; and
3) Use this method from year to year unless the Internal Revenue Service allows you to change to another method.

***Records must be kept*** for each separate department or class of goods carrying differ-

ent percentages of gross profit. Purchase records should show the firm name, date of invoice, invoice cost, and your retail selling price. You should also keep records of the respective departmental or class accumulation of all purchases, markdowns, sales, stock, etc.

**Closing inventory, cost.** Under the retail method the total of the retail selling prices of goods on hand at the end of the tax year in each department or class of goods is reduced to approximate cost using the average markup expressed as a percentage of the total retail selling prices.

Figure the average markup percentage by:

1) Adding the total of the retail selling prices of the goods in the opening inventory and the retail selling prices of the goods you bought during the year (adjusted for all markups and markdowns); then
2) Subtracting from that total the cost of goods included in the opening inventory plus the cost of goods you bought during the year; and then
3) Dividing the balance by the total selling price (item 1).

You can figure approximate cost in two steps. First, find the markup in the items in the closing inventory by multiplying the total retail selling prices by the average markup percentage. Then, subtract the markup from the total retail selling prices. The result is the approximate cost.

If you have been figuring your inventory under the retail method (except that you have followed the consistent practice of adjusting the retail selling prices of goods for markups but not markdowns) you may continue that practice provided the adjustments are bona fide and uniform and markups made to cancel or correct markdowns are also excluded. The markups included must be reduced by markdowns made to cancel or correct the markups.

If you previously figured inventories without eliminating markdowns in making adjustments to retail selling prices, you may use this practice, provided you first get permission to do so from the Internal Revenue Service. In the first tax return you file for your business, you may use this practice subject to approval by the Internal Revenue Service on examination of your tax return.

If you use LIFO with the retail method, adjust your retail selling prices for markdowns as well as markups.

***Example.*** Your records show the following information on the last day of your tax year

| Item | Cost | Retail Value |
|---|---|---|
| Opening inventory | $52,000 | $60,000 |
| Purchases during year | 53,000 | 78,500 |
| Sales | | 98,000 |
| Markups | | 2,000 |
| Markdowns | | 500 |

Using the retail method you can figure your closing inventory from this information as follows:

| Item | Cost | | Retail Value |
|---|---|---|---|
| Opening inventory | $ 52,000 | | $ 60,000 |
| Plus: Purchases during year | 53,000 | | 78,500 |
| Markups | | $2,000 | |
| Markdowns | | 500 | 1,5000 |
| Totals (markup percentage 25%) | $105,000 | | $140,000 |
| Minus: Sales | | | 98,000 |
| Closing inventory at retail | | | $ 42,000 |
| Minus: Markup percentage (25%) | | | 10,500 |
| **Closing inventory at cost** | | | $ 31,500 |

***Markup percentage.*** In the preceding example, the markup ($35,000) is equal to the difference between cost ($105,000), which includes inventory at the beginning of the period; and purchases at cost plus transportation, and the retail value ($140,000), which included the inventory at sales prices and purchases at sales prices. The total markup divided by the total retail value will give you the percentage (25%) of purchase markup. Do not use arbitrary standard percentages of purchase markup. The percentage must be the markup percentage figured as accurately as possible from your department records for the period for which you file your return.

***Markdowns*** not based on actual reduction of retail sales prices (such as markdowns based on depreciation and obsolescence) are not allowed in figuring retail selling prices of the goods on hand at the end of the tax year. Markdowns are recognized only if you offered the goods to the public at the reduced prices, or if you provide proof of market changes that have forced a reduction in retail prices.

**Used with other methods.** The retail method may be used with the FIFO and specific identification methods. Subject to special rules, the retail method also may be used in conjunction with the LIFO method.

## Changing Your Method of Accounting

When you file your first return, you may, without the consent of the Commissioner, choose any appropriate method of accounting. The method you choose must clearly show your income and this same method must be used from year to year.

After that, if you want to change your method of accounting you must first get the consent of the Commissioner. This is necessary to notify the Internal Revenue Service that a change is being made and to prevent you from gaining an unlawful tax advantage.

A change in the method of accounting includes a change not only in your overall system of accounting but also in the treatment of any material item. Although an accounting method may exist without having a pattern of treating an item the same way all the time, in most cases, a method of accounting is not established for an item unless the item is treated the same way every time.

Some examples of changes that ***require*** consent are:

1) A change from the cash method to the accrual method or vice versa; and
2) A change in the method or basis used to value inventories; and
3) A change in the method of figuring depreciation (except certain changes to the straight line method as explained in Publication 534); and
4) A change from the cash or accrual method to a long-term contract method or vice versa.

Some changes that are not changes in accounting methods and ***do not require*** consent are:

1) A correction of mathematical or posting errors; and
2) An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it; and
3) An adjustment of an addition to a reserve for bad debts; and
4) An adjustment in the useful life of a depreciable asset; and
5) Election of the Class Life Asset Depreciation Range (CLADR) System for figuring depreciation allowances, as discussed in Publication 534.

**How to secure consent.** Unless you are making a change under Revenue Procedure 74-11 (discussed later) you must file Form 3115, *Application for Change in Accounting Method*, with the Commissioner of Internal Revenue, Attention T:C:C:1, Washington, D.C. 20224.

Form 3115 is available at your Internal Revenue office. You must furnish all the applicable information requested on the form. You also may be required to provide additional information.

In most cases you must file the application within the first 180 days of the tax year for which you are requesting the change. If the 180th day falls on a Saturday, Sunday, or a legal holiday, the filing date is extended to the next working day. Thus a calendar year taxpayer wanting to change accounting methods for 1981 must file by June 29, 1981.

***Change from cash method to accrual method.*** If you want to change your accounting method from the cash method to an accrual method, you must receive consent from the Internal Revenue Service. You may apply by filing Form 3115, as explained previously. You should furnish all information requested on that form.

Your request to change from the cash method to the accrual method will usually be approved if you proposed and agree to take the necessary adjustments into account over an appropriate period of time as directed by the Internal Revenue Service, usually 10 years. You should request the application of Revenue Procedure 70-27, 1970-2 C.B. 509 as amplified by Revenue Procedure 75-18, 1975-1 C.B. 687.

An application on Form 3115 filed after the 180-day period but within 9 months after the beginning of the tax year for which the change is requested may be treated as filed on time if you show reasonable cause for filing it late.

***Simplified procedures*** now exist In which you may presume to have the Commissioner's consent in changing your method of figuring depreciation to another specified method. See Revenue Procedure 74-11, 1974-1, C.B. 420. There is also a simplified procedure for changing from the specific charge-off method to the reserve method of accounting for your bad debts. See Revenue Procedure 64-51, 1964-2 C.B. 1003, as modified by Revenue Procedure 77-39, 1977-2 C.B. 573. You may get copies of these procedures from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

File your application on Form 3115 under Revenue Procedure 74-11 with the Service Center where you file your return and under Revenue Procedure 64-51 as modified by Revenue Procedure 77-39 with the Commissioner of Internal Revenue as explained earlier. If you follow the steps outlined in the procedures and comply with all the provisions, you may assume consent has been granted unless you are notified otherwise.

***Extensions of time to secure consent.*** If you have a good reason for filing late, the Commissioner of Internal Revenue may grant you an extension. The Commissioner may grant an extension if:

1) The Internal Revenue regulations and not the Internal Revenue Code set the time for making an application or change; and
2) You file the request for an extension with the Commissioner within a period of time the Commissioner considers reasonable under the circumstances; and
3) You can show to the Commissioner's satisfaction that granting the extension will not jeopardize the government's interests.

See Revenue Procedure 79-63, 1979-2 C.B. 578, for the factors that will be considered in deciding whether or not you have an acceptable reason for filing late and have met the requirements.

**Examination of return.** If your return is being examined by the Internal Revenue Service and the issue involves a change in accounting practice or method, you may request application of Revenue Procedure 70-27, 1970-2 C.B. 509, as amplified by Revenue Procedure 75-18, 1975-1 C.B. 687. In this case, the revenue procedure generally will apply to the most recent tax year (year of transition) for which you filed a federal income tax return as of the date the examination began. Your request for application of the revenue procedure should be made in a letter to the Commissioner of Internal Revenue, Attention T:C:C. This request should be sent to the District in which the return is being examined, who will forward it with comments to the national office. You should send a completed Form 3115 with the letter. Pending action by the national office, the District Director will suspend action on the particular issue.

After you make your request, you may ask for a conference in the national office to discuss the matter. Revenue Procedure 70-27 does not apply to cases under examination by the Service in which the year or years under examination encompass the tax year in which you started the practice or method that is at issue. Also, Revenue Procedure 70-27 does not apply when you change to the full absorption method of inventory costing.

## How to Figure Net Profit

The following example illustrates a combination of both the accrual and the cash methods.

Gross profit from sales in the example is figured under an accrual method.

Expenses of doing business, other than cost of goods sold, are deducted under the cash method.

***Example.*** You operated a retail grocery store during 1980. Your cash sales were $63,025, and your sales on open account were $9,035—a total of $77,060. You had an opening inventory of $7,845 and a closing inventory of $7,955. Merchandise purchases, less the cost of items you withdrew for personal use during the year, totaled $60,250. This figure of $60,250 contains purchases you did not pay for by the end of 1980. Your expenses were $7,375, which included $250 depreciation on store fixtures, business bad debts of $110, rent of $200 a month (you paid for only 11 months) and repairs of $25. (You still owed $50 for repairs which may not be deducted until you actually pay them.) Your net profit from the business is figured as follows:

**PROFIT AND LOSS STATEMENT**

**YEAR ENDED DECEMBER 31, 1980**

| | | |
|---|---|---|
| Sales (less returns and allowances) | | $77,060 |
| Minus Cost of Goods Sold: | | |
| Inventory 1/1/80 | $ 7,845 | |
| Purchases (less personal items) | 60,250 | |
| Goods available for sale | $68,095 | |
| Less Inventory 12/31/80 | 7,955 | |
| Cost of Goods Sold | | 60,140 |
| Gross Profit | | $16,920 |
| Minus Expenses: | | |
| Rent | $2,200 | |
| Interest | 150 | |
| Licenses | 120 | |
| Bad debts | 110 | |
| Depreciation | 250 | |
| Repairs | 25 | |
| Other business expenses | 4,520 | 7,375 |
| **Net profit from business** | | $ 9,545 |

**Discounting notes receivable** is a common practice in some businesses. Many dealers receive the notes of customers as part payment for articles sold. These notes are payable over a fixed period. The dealer then sells the notes to a finance company at a discount. The dealer and the finance company often agree that a part of the discount price will be held by the finance company in a ***dealer's reserve*** or similar account until collections are made or the reserve reaches a specified total, at which time it will be paid over or credited to the dealer. In these cases, amounts held in the reserve are treated as income. Under an accrual method of accounting the full amount of the ***discount price,*** not reduced by the reserve held by the finance company, is included in income when the notes are sold. This practice is often followed by automobile dealers.

***Losses on worthless notes*** that the finance company may charge against the reserve have no bearing on the fact that taxable income has been received by the dealer.

**Repaying income previously reported.** If you included an amount in your income because you thought that you had an unrestricted right to it and in a later year you are required to repay all or a part of it, because it turns out that you did not have an unrestricted right to it, a special rule may apply. Usually you may deduct the repayment in the year in which you make it. If the income item gave rise to a deduction in the year you included it in income, any deduction for the amount you repay is limited to the net amount you included in income in the prior year.

The character of the deduction in the year of repayment depends on the character of the income you included in the earlier year. For instance, if you repay an amount previously reported as a long-term capital gain, the repayment is deductible as a long-term capital loss.

***Example.*** You use the cash method of accounting. In 1979 you were involved in a lawsuit resulting from a contract dispute with Doe Corporation. The dispute was over how much was owed to you; the court decided in your favor for $2,000. Although Doe Corporation said it would appeal the judgment, it was ordered by the court to pay you immediately without restriction. As promised, Doe Corporation appealed the case and won; the appellate court reversed the lower court's judgment in June 1980. You repaid the $2,000 you received in 1979.

You had to include the $2,000 in your income for 1979 because you had an unrestricted right to it. No deduction arose from inclusion. In 1980 you may deduct the $2,000 repayment.

***If the amount you repaid is over $3,000,*** you should figure your tax two ways:

1) Figure your tax for this year claiming a deduction for the repaid amount.
2) Figure your tax for this year without deducting the repaid amount. Then reduce this tax by the amount your tax in the earlier year was increased because you included in income the amount you later had to repay.

Your tax is the amount in (1) or (2), whichever is less.

If you figure the tax for the year of repayment under method (2), the amount repaid may not be deducted in figuring a net operat-

ing loss for the year of repayment but is taken into account in figuring the decrease in tax for the prior tax yaer.

This discussion does not apply if your deduction results from sales of inventory items to your customers in the ordinary course of your trade or business. It does not apply, therefore, to sales returns and allowances and similar items. Nor does it apply to deductions because of bad debts or to legal fees and other expenses you had in contesting the repayment of income you previously included.

It does apply to deductions because of refunds or repayments made by a regulated public utility on rates, if the refunds or repayments are ordered by the government, a political subdivision, certain regulatory bodies, a court order, or are made in settlement of litigation or under threat of litigation.

***How to account for these repayments.*** If you use the cash method, and you want to claim a deduction in the later year for an item of income that you included in an earlier year under a claim of right, you must actually repay the amount. If you constructively received and included in income an amount you never actually received, you may deduct that amount in your tax year in which you are required to give up your right to receive it. If you use any other accounting method, you may deduct the repayment only in the proper tax year under that accounting method.

## Contested Liabilities

If you contest an asserted liability for any of your business expenses, the amount you paid may or may not be deductible in the year you paid it.

**If you use the cash method** you may deduct the contested liability for allowable business expenses only in the year you paid it.

**If you use an accrual method** you must deduct certain contested liabilities, such as taxes (except foreign taxes), in the tax year in which you pay them, or transfer money or other property to satisfy the obligation, rather than in the tax year in which the contest is settled. However, for the deduction to be allowed in the year of payment or transfer, you must satisfy each of the following rules.

***You must contest an asserted liability.*** You do not have to start a suit in a court of law to contest an asserted liability. However, you must deny its validity or accuracy by a positive act. A written protest included with payment of an asserted liability is enough to start a contest. Lodging a protest in accordance with local law is enough to contest an asserted liability for taxes. You do not have to deny the validity or accuracy of an asserted liability in writing if you can show by all the facts and circumstances that a liability has been asserted and contested.

***You must transfer to the creditor*** or other person, enough money or other property to cover the payment of the asserted liability. The money or other property transferred must be beyond your control. If you transfer it to an escrow agent, you have met this requirement if you give up all authority over the money or other property. Buying a bond to guarantee payment of the asserted liability, making an entry on your books of account, or transferring funds to an account within your control will ***not*** meet this requirement.

***The contest*** for the asserted liability must exist after the time of the transfer. If you do not make payment until after the contest is settled, you must accrue the liability in the year in which the contest is settled.

***Example.*** You are a calendar year taxpayer using the accrual method of accounting, and you had a $100 liability asserted against you in 1977. You contested this asserted liability and finally settled in 1980 for the full $100. You will pay the $100 in 1981. Since you did not make the payment until after the contest was settled, the liability will accrue and be deductible in 1980.

***The liability*** must have been allowable as a deduction in the year of payment, or in an earlier year when it would have accrued, if there had been no contest.

**Recovered amounts.** If you recover any part of the contested liability that you deducted in the tax year of payment in a later tax year when the contest is settled, an adjustment is usually necessary. You do this by including in gross income in the tax year of final settlement the part of the recovered amount that, when deducted, decreased your tax for any tax year.

***Foreign taxes and taxes of U.S. possessions.*** The rule allowing the deduction of contested liabilities in the tax year of payment does not apply to the ***deduction*** for income, war profits, and excess profits taxes imposed by any foreign government or U.S. possession. Thus, an accrual method taxpayer deducts these liabilities in the tax year in which the contested foreign tax or U.S. possession tax is finally determined. Contested foreign taxes accrued for ***credit*** are not covered under this provision but relate back and are creditable in the tax year in which they would have been accrued if they had not been contested.

## Trading Stamps

If you issue trading stamps or premium coupons with your sales and you redeem these stamps or coupons, you may reduce your gross receipts. This reduction is also permitted if you are in the business of selling trading stamps or premium coupons that you redeem. You must be an accrual method taxpayer to make this reduction.

Your gross receipts from stamp or coupon sales (or from the sales for which the stamps or coupons are issued) should be reduced by an amount equal to:

1) Your cost of merchandise, cash, or other property used for redemptions in the tax year; and
2) The net addition to, or subtraction from, the provision for future redemptions during the tax year.

You will be treated as being in the business of selling trading stamps or premium coupons if:

1) The trading stamps or premium coupons sold are issued by purchasers to promote the sale of your merchandise or services; and
2) The principal activity of your business is the sale of trading stamps or premium coupons; and
3) The stamps or coupons may be redeemed for a period of at least one year from the date of sale; and
4) Based on your experience, you estimate that no more than two-thirds of the stamps or coupons sold will be redeemed within 6 months of the sale date.

***The provision for future redemptions*** as of the end of a tax year is figured by multiplying estimated future redemptions by the estimated average cost of redeeming each trading stamp or coupon. The term estimated future redemptions as of the end of a tax year means the number of trading stamps or coupons outstanding that you ultimately expect to redeem.

***Five-year rule.*** Figure estimated future redemptions by:

1) Finding the percentage which the total number of stamps or coupons redeemed in the tax year and the 4 preceding tax years is of the total number of stamps or coupons issued or sold in those 5 years; and
2) Multiplying that percentage by an appropriate growth factor according to the guidelines provided by the Internal Revenue Service in Revenue Procedure 72-36, 1972-2 C.B. 771.

You may estimate the volume of stamps expected to be redeemed after the close of any tax year by any of the following methods:

1) A ratio method; or
2) The probability sampling method; or
3) A synthetic or reconstructive method; or
4) Any actuarial, statistical or other mathematical method, provided that you can demonstrate satisfactorily that such a method will produce a sound and acceptable measurement of the volume of stamps you expect to redeem after the close of any tax year.

These methods are discussed in detail in Revenue Procedure 72-36.

You must choose a method that is appropriate to your experience and circumstances. If the Internal Revenue Service does not find that your method is appropriate and produces reasonably accurate results, you will have to refigure your estimated volume in a manner that is satisfactory to the Internal Revenue Service.

***Other methods.*** You may figure your estimated future redemption by any other method, including probability sampling tech-

niques, the accuracy of which can be demonstrated to the satisfaction of your local District Director.

***Information to furnish with your return.*** If you figure your estimated future redemptions under the 5-year rule, file with your return a statement showing the total number of stamps or coupons issued or redeemed for the last five tax years. If you use any other method, file with your return the information necessary to establish the correctness of the amount you subtracted from gross receipts in the tax year.

## Returns of Magazines, Paperbacks, and Records

If you are a distributor of magazines, paperbacks, or records and use an accrual method of accounting, you may elect to exclude from gross income for tax years beginning after September 30, 1979, the income from the qualified sales of magazines, paperbacks, or records that are returned to you before the close of your merchandise return period. You do not need the permission of the Commissioner of the Internal Revenue Service to make this election.

**A magazine** includes any periodical other than newspapers.

**A paperback** is any book that has its pages directly connected to a flexible outer cover and that is not a magazine.

**A record** is a disk, tape, or similar object on which musical, spoken, or other sounds are recorded. It does not include any blank materials on which purchasers are expected to make their own recordings.

**A qualified sale** is a sale of a magazine, paperback, or record if:

1) You have at the time of the sale, a legal obligation to adjust its sales price if it is not resold; and
2) You adjust its sales price because your customer failed to resell it.

**The merchandise return period** means:

1) For magazines, the first 2 months and 15 days after the close of the tax year; or
2) For paperbacks or records, the first 4 months and 15 days after the close of the tax year.

You may choose a shorter period. However, if you later want to change the length of the period, the change will be treated as a change in your accounting method.

The magazines, paperbacks, or records must be returned to you before the close of the return period. The return of the merchandise may be satisfied by their physical return, by certification, or by other evidence that they have not been resold and they will not be resold. The exact means of satisfying the latter procedure will be set by regulations. You must have in your possession either the physically returned merchandise or the allowable substituted evidence at the end of the merchandise return period.

You may use this method of accounting for merchandise returns only if you elect to use it for the business in which these merchandise sales are made. If you sell two or more categories of merchandise such as magazines and records in the same business, each category is treated as a separate business for this election.

For example, if you sell both magazines and paperbacks in a single business, for the purpose of electing this method of accounting for returns, magazine sales will be treated as one business and paperback sales will be treated as another business. So, if you want to use this method of accounting for returns of both magazines and paperbacks, you must make a separate election for each category.

**Transitional adjustment for returns of magazines.** If you elect this method to account for magazine returns, there is a special 5-year amortization period for the transitional adjustment.

**Suspense accounts for paperbacks and records.** If you choose this method to account for paperback and record returns, the transitional adjustment is held in a suspense account. You establish separate suspense accounts for paperback returns and for record returns.

***Initial opening balance.*** To figure the initial opening balance of the suspense account for the first tax year that you use this method, you must determine the dollar amount of merchandise returns that would have been excluded from your gross income for each of the three preceding tax years as if the election had been in effect for each of those years. The opening balance of the suspense account is the largest dollar amount found for any of the three prior years.

***Initial adjustment.*** If the opening amount in the suspense account is more than the actual returns during the merchandise return period of the tax year immediately before the tax year that you elect to use this method, include the excess in income in the tax year in which you first choose to use this method.

***Annual adjustments.*** Adjustments are made to the suspense account each year to record fluctuations in merchandise returns. To figure the annual adjustment, you must determine the amount to exclude from gross income for the tax year for merchandise returns. If this amount is less than the opening balance in the suspense account for the tax year, the account is reduced by the difference. However, if the amount is more than the opening balance in the suspense account for the tax year, the account is increased by the difference (but not to more than the initial opening balance). Adjustments that reduce the suspense account reduce gross income for the tax year. Adjustments that increase the suspense account increase gross income for the tax year.

***Example.*** You are a paperback distributor on the accrual method of accounting. For the tax year ending December 31, 1981, you make a timely election to exclude from your gross income the income from the qualified sale of paperbacks that are returned to you before the close of your merchandise return period. You use a 4 month and 15 day return period.

If the paperbacks returned to you in the first 4 months and 15 days of 1979, 1980, and 1981 were worth $5,000, $8,000, and $6,000 respectively, then the initial opening balance in the suspense account on January 1, 1981, would be $8,000 (the largest dollar amount of returns for the three previous years).

Since the initial opening balance is more than the actual returns in the first 4 months and 15 days of the tax year for which the election is first effective ($6,000 in 1981), the excess of $2,000 is added to gross income for 1981. Your actual returns in the first 4 months and 15 days of 1982, 1983, and 1984 are $5,000, $7,000, and $10,000, respectively. Therefore, the computation of the exclusion from income for the years ending December 31, 1981, 1982, and 1983 would be as follows:

| | Years Ending December 31 | | |
|---|---|---|---|
| | 1981 | 1982 | 1983 |
| Adjustment to suspense account: | | | |
| Opening balance | $ 8,000 | $ 5,000 | $ 7,000 |
| Addition to account | | 2,000 | 1,000 |
| Reduction to account | (3,000) | | |
| Opening balance for next year | $ 5,000 | $ 7,000 | $ 8,000 |
| Amount excludable from income: | | | |
| Initial year adjustment | $(2,000) | | |
| Amount excludable as actual returns in merchandise return period | 5,000 | $ 7,000 | $10,000 |
| Adjustment for increase in suspense account | | (2,000) | (1,000) |
| Adjustment for decrease in suspense account | 3,000 | | |
| Net amount excludable for the year | $ 6,000 | $ 5,000 | $ 9,000 |

**Making the election.** To make the election file Form 3115 with your return for the first tax year that you want to use this method. Your election must be made no later than the due date of your return (including extensions) for the first tax year for which you make the election. You may ***not*** make the election with an amended return filed after the due date (including extensions) for filing your original return for the tax year of change.

The election is effective until you get the permission of the Commissioner to revoke your choice.

***Form 3115*** must state that you are making an election under section 458(c) of the Internal Revenue Code. It should contain the following information:

1) Your name, address, and identification number; and
2) A description of each trade or business for which you are making the election; and
3) The first tax year for which you are making the election for each trade or business; and

4) The merchandise return period for each trade or business covered by the election; and
5) For an election that applies to magazines, the adjustment figured under section 481(a) of the Internal Revenue Code that results from your changing to this method; and
6) For an election that applies to paperbacks or records, the opening balance in the suspense account for each trade or business for which you are making this election.

## Qualified Discount Coupons

If you are a wholesaler or manufacturer of products that are distributed through retail stores, you may elect to deduct from your gross income for tax years ending after 1978, the redemption costs of qualified discount coupons that you had outstanding at the end of the year and you received before the close of your redemption period. You do not need the permission of the Commissioner of the Internal Revenue Service to do this.

**A qualified discount coupon** is a discount coupon that:

1) Is issued by you; and
2) Is redeemable by you; and
3) Allows a discount on the purchase price of merchandise or other tangible personal property.

It is ***not*** a qualified discount coupon if:

1) The face amount of the coupon is more than $5; or
2) The coupon may be used with other coupons to make a price discount of more than $5 for any item; or
3) The coupon is redeemable for a discount on the price of services or real property; or
4) If you redeem it directly from the person using it to receive a price discount. For this rule, corporations that are members of the same controlled group of corporations will be treated as the issuer. See Publication 542, *Tax Information on Corporations*, for a definition of a controlled group of corporations.

How you issue a coupon will not determined if it is a discount coupon. You may issue it through a newspaper, magazine, or any other publication, or by mail or in or on a package or merchandise or in any other manner. The coupon does not have to be printed on paper. It may be in the form of a token or other object.

**The redemption period** for a tax year is the 6 month period immediately following the close of that tax year. You may select a redemption period that is shorter than 6 months. However, any later change in the redemption period will be treated as a change in the method of accounting.

**The redemption cost** of a coupon is the lesser of:

1) The amount of the discount provided by the terms of the coupon; or
2) The amount you owe for the discount, plus the amount you pay the retailer or other person who accepts the coupon for redeeming it, but only if the amount payable is stated on the coupon.

***Example.*** You manufacture laundry products, and you print a coupon on your boxes of soap that gives the customer a discount of 25 cents on the purchase of the next box of soap. The coupon states that the grocer or other retailer who redeems the coupon will be paid five cents a coupon for redeeming it. The redemption cost of this coupon for this election is 30 cents.

**Suspense account.** Your election of this treatment of qualified discount coupons usually requires an adjustment to your income from a change in accounting method. If the adjustment would result in a net decrease in your taxable income, you must set up a suspense account. If the adjustment would result in a net increase in your taxable income, you would take that adjustment into income spread equally over the 10-year period that begins with the year of change.

***Initial opening balance.*** Figure the initial opening balance in the suspense account for your first tax year for which the election is effective by figuring the dollar amount of the deduction for coupons received during the redemption period that would have been allowed for each of your 3 preceding years under this election if it had been in effect for these years. The initial opening balance is the largest dollar amount figured for any one of the 3 prior years, reduced by the sum of the adjustments due to the change in method of accounting that increases income for the year of change.

***Initial year adjustment.*** If, in figuring your initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the 3 prior years is more than the actual cost of redeeming coupons received during the redemption period of the year immediately preceding the year of election, include the excess in your income in the year of election.

***Annual adjustments.*** You make adjustments to the suspense account each year to account for fluctuations in redemptions. To figure the annual adjustment, you must know the redemption cost of qualified discount coupons that were returned to you during the redemption period for the tax year. If this amount is less than the opening balance in the suspense account for the tax year, reduce the account by the difference. However, if the amount is more than the opening balance in the suspense account for the tax year, increase the account by the difference (but not to an amount more than the initial opening balance). Adjustments that reduce the suspense account are deductions for the tax year; adjustments that increase the suspense account increase gross income for the tax year.

***Example.*** As a manufacturer who issues qualified discount coupons, you make a timely election to exclude from gross income the redemption costs of qualified discount coupons that were outstanding at the end of the year and were received before the close of your redemption period for the year ending December 31, 1980. You choose the 6 month redemption period. The qualified discount coupons returned to you in the first 6 months of 1978, 1979, and 1980 were $7,000, $13,000, and $8,000, respectively. The accounting change adjustments that increase income in the year of change are $2,000.

| | |
|---|---|
| Actual coupons redeemed in the first 6 months of 1980 | $8,000 |
| Minus: Accounting change adjustments that increase income in 1980 | 2,000 |
| Net adjustment decreasing income in 1980 under section 481(a)(2) | $6,000 |

Because the preceding computation results in a net decrease in income for 1980, you must use a suspense account.

The initial opening balance in the suspense account on January 1, 1980, would be:

| | |
|---|---|
| Largest dollar amount of qualified coupon redemptions in the 3 preceding years | $13,000 |
| Minus: Accounting change adjustments that increase income in 1980 | 2,000 |
| Initial opening balance | $11,000 |

Because the coupon redemptions taken into account in figuring the initial opening balance are more than the actual redemptions in the first 6 months of the year of change (1980), your initial year adjustment is figured as follows:

| | |
|---|---|
| Largest dollar amount of qualified coupon redemptions in the 3 preceding years | $13,000 |
| Minus: Actual redemptions in the first 6 months of the year of change | 8,000 |
| Initial year adjustment | $ 5,000 |

Your actual returns in the first 6 months of 1981, 1982, and 1983 are $7,000, $10,000, and $12,000 respectively. The exclusion from income for the years ending December 31, 1980, 1981, 1982, is as follows:

| | Years Ending December 31 | | |
|---|---|---|---|
| | 1980 | 1981 | 1982 |
| Adjustments to suspense account: | | | |
| Opening balance | $11,000 | $ 7,000 | $10,000 |
| Addition to account | | 3,000 | 1,000 |
| Reduction to account | (4,000) | | |
| Opening balance for next year | $ 7,000 | $10,000 | $11,000 |
| Amount deductible: | | | |
| Initial year adjustment | $(5,000) | | |
| Amount deductible as actual coupon redemptions during redemption period | 7,000 | $10,000 | $12,000 |
| Adjustment for increase in suspense account | | (3,000) | (1,000) |
| Adjustment for decrease in suspense account | 4,000 | | |
| Net amount deductible for the year for coupons redeemed during the redemption period | $ 6,000 | $ 7,000 | $11,000 |

**Making the election.** To make the election, file Form 3115 with your return for the first tax year that you want to use this method.

Your election must be made no later than the due date of your return (including extensions) for the first tax year for which you make the election. You may ***not*** make the election with an amended return that is filed after the due date (including extensions) for filing the original return for the tax year of change. The election continues until you get the permission of the Commissioner to revoke your election.

***Form 3115*** must state that you are making an election under section 466 of the Internal Revenue Code. It should also contain the following information:

1) Your name, address, and identification number; and
2) A description of each trade or business for which you are making the election; and
3) The first tax year for which you are making an election; and
4) The redemption period for each trade or business covered by the election; and
5) The initial opening balance for each suspense account you must establish; and
6) For an election that results in a net increase in income, the amount of the increase.

You make the election for the trade or business through which you issue the coupons. It applies to all qualified discount coupons you issue through that trade or business. Your computation of taxable income under this election will be treated as a method of accounting.

## Long-Term Contracts

Special accounting methods may be used for reporting income from long-term contracts. A long-term contract is a building, installation, construction, or manufacturing contract that is not completed in the tax year in which it is entered into.

A manufacturing contract is a long-term contract only if it involves manufacturing unique items of a kind not normally carried in the finished goods inventory, or items that normally require more than 12 months to complete (regardless of the duration of the contract). For example, a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the manufacturer's inventory or a contract to manufacture machinery that requires more than 12 months to complete are long-term contracts. However, a contract to manufacture 15,000 folding chairs that take 3 days each to make is not a long-term contract even if it takes more than 12 months to finish the job, and the contract is not completed within the tax year it is entered into.

Income from a long-term contract may be included in gross income by either the percentage of completion method, the completed-contract method, or the accrual method. Whichever method is used, it must be consistently used for all long-term contracts within the same trade or business. However, if you have several long-term contracts in the same trade or business some of which take a long time and some which do not, you may report the income from all the long-term contracts on the same long-term contract method and report the income from the shorter contracts under the accrual method.

***Example 1.*** You are a machinery manufacturer and you have special-order contracts for a type of machinery that usually takes 15 months to complete and you also have contracts for a type of machinery that usually takes 3 months to complete. You may use a long-term contract method for the 15-month contracts and the accrual method for the 3-month contracts.

***Example 2.*** You are a construction contractor and you have construction contracts of a type that usually take 15 months to complete and other construction contracts that take only 5 months to complete but that are long-term contracts because they are not completed in the tax years in which they are entered into. You may either use a long-term contract method for all the contracts of both types or use a long-term contract method for the 15-month contracts and the accrual method of accounting for the 5-month contracts.

***You must attach a statement*** to your tax return indicating that you are using one of the long-term contract methods of accounting each year you report income in that way. Contracts involving only the sale of completed property do not qualify.

**The percentage of completion method** provides that you report as gross income only the part of the contract price that represents the percentage of the contract completed during your current tax year.

To determine the percentage of completion of a contract, you may generally use one of the following methods:

1) Compare, as of the end of the tax year, the costs you had under the contract with the estimated total contract costs; or
2) Compare, as of the end of the tax year, the work performed on the contract with the estimated work to be performed.

In making the cost comparison, you may use any method (such as a comparison of the total direct and indirect costs you had to date with the estimated total direct and indirect costs) as long as that method is used consistently and clearly shows income. Likewise, in making the work performance comparison, the criteria used must clearly show the earning of income under the contract.

If you use the first method (cost comparison) and revise the estimated total costs as of the end of the tax year, a certificate of an architect or engineer or other documentation showing what the revision is based on must be available at your principal place of business for inspection in connection with an examination of your income tax return.

If you use the second method (work performed comparison) a certificate of an architect or engineer or other documentation showing the percentage of completion must be available at your principal place of business for inspection in connection with an examination.

Deduct all costs that you had during your tax year for the contract. However, to figure the deduction for materials and supplies, add the cost of the materials and supplies on hand at the beginning of the year to purchases during the year and subtract the material and supplies on hand at the end of the year. Do not deduct costs for any guarantee, warranty, maintenance, or other service agreement for the subject matter of the contract. This kind of expenditure is accounted for under the other accounting methods you use.

***Example.*** You have a contract to construct a building. The contract was signed June 23, 1980, and provides for payment of $180,000 for a building to be completed by November 16, 1981. You began construction July 3, 1980. You use the calendar year as your tax year. You choose to use the percentage of completion method. Figure the percentage of completion of the contract by comparing, at the end of the year, the work performed on the contract with the estimated total work to be performed. The architect certified that 25% of the work was completed on December 31, 1980. You will report $45,000 of gross income from the contract for 1980. You will also deduct all your 1980 expenses for the contract, taking into account your materials and supplies on hand at the end of the year.

**The completed-contract method** provides that you report gross income from a long-term contract and deduct all expenses (direct labor and direct material) related to the contract in the year the contract is finally completed and accepted. However, you may not deduct the cost of any materials and supplies charged to the work under the contract that remain on hand when you finish. Depreciation and other indirect costs and overhead must be allocated to specific jobs. Indirect costs that must be allocated include the repair, maintenance, and rent of equipment or facilities used in completing a long-term contract. Also included are deductible taxes (including excise taxes paid to do business within a state) related to labor, materials, supplies, equipment, or facilities used in completing a long-term contract. As in the percentage of completion method, you may not deduct the costs for any guarantee, warranty, or other service agreement work for the contract.

***Example.*** You are a contractor who uses the completed-contract method. You signed a contract in 1978 to construct a building that was completed and accepted in 1980. Your expenses for the job were $50,000 during 1978, $90,000 during 1979, and $30,000 during 1980. You received $80,000 during 1978, $100,000 during 1979, and $35,000 during 1980 as payments on the contract. Your income tax returns for 1978 and 1979 show no income or expenses for this contract. Your in-

come tax return for 1980 will show the total income and expenses of this job and will show your profit of $45,000 from this contract.

***Disputes.*** If you are a manufacturer or a contractor, there are certain rules that must be followed when there are disputes between you and the buyer under the completed contract method.

If the ***buyer*** wants to have the original contract price reduced or to have additional work performed on the contract, you must take any disputed item of income or deduction into account in the tax year in which the dispute is resolved.

If the disputed amount affects so much of the contract price that it is not possible to determine whether you will ultimately realize a profit or loss on the contract, none of the income or deductions pertaining to the contract may be included in or deducted from your gross income in the tax year in which the contract is completed (without regard to the dispute).

In all other cases, you must include the entire amount of the gross contract price reduced (but not below zero) by the amount in dispute in your gross income in the tax year in which the contract is completed (without regard to the dispute).

If you are assured of a profit on the contract regardless of the outcome of the dispute, then you must deduct all costs of the contract that you had before the end of the tax year in which the contract is completed (without regard to the dispute) in that year.

If you are sure of a loss on a contract regardless of the outcome of the dispute, then you must deduct in the tax year in which the contract is completed (without regard to the dispute) the total costs of the contract that you had before the end of that year reduced by the amount by which the gross contract price was reduced. Deduct all other costs of the contract in the tax year in which you had them.

If there is additional work to be performed on a contract in dispute, the term, ***tax year in which the dispute is resolved,*** means the tax year in which the work is completed, rather than the tax year in which the outcome of the dispute is determined by agreement or decision.

If ***you*** request an increase in the amount to be paid to you under the contract, you must include the entire amount of the gross contract price in your gross income in the tax year in which the contract is completed (without regard to the dispute). Deduct all costs for the contract that you had before the end of the year in that year.

Include any item of income related to the contract that has not been included in your gross income as mentioned in the previous paragraph in your gross income in the tax year in which the dispute (or part of it) is resolved. You take any item of deduction that you have in a tax year after the contract is completed (without regard to the dispute) from your gross income in the tax year in which you have the expense. Gross contract price means the original stated price of the contract with any agreed upon modifications as of the end of the tax year.

If ***both you and the buyer*** have a dispute, such as you requesting an increase in the contract price and the buyer wanting either a reduction in the contract price or additional work performed, these rules will apply.

**Severing and aggregating contracts.** To clearly show income it may be necessary either to treat one agreement as several contracts or to treat several agreements as one contract. Whether an agreement should be severed or several agreements aggregated depends on all the facts and circumstances. Usually, one agreement will not be treated as several contracts unless the agreement anticipates separate delivery or acceptance of parts of the subject matter of the contract or unless there is no business purpose for entering into one agreement rather than several agreements. However, separate delivery or separate acceptance does not necessarily require severing of a contract.

Several agreements are not usually aggregated unless these agreements would be treated as one contract under customary commercial practice in your trade or business or unless there is no business purpose for entering into several agreements rather than one agreement.

***Example.*** You are a calendar year shipbuilder who uses a long-term contract method. You enter into two contracts at about the same time during 1980 with the Able Fishing Co. These contracts result from a single negotiation. Under each contract you are to build a fishing vessel of the same type or class for the Able Fishing Co. Although the specifications for each vessel are similar, you expect that, since you have never built this kind of vessel before, your costs in building the first vessel (to be delivered in 1981) will be substantially more than the costs of building the second vessel (to be delivered in 1982). If the contracts are treated as separate contracts, the first contract would probably result in little or no gain, while the second contract would result in substantial profits. You would not have contracted to buld the first vessel for the price specified without contracting for the second vessel. In these circumstances, you must treat the two contracts as one contract for the purpose of applying your long-term contract method.

**Other expenses,** such as office salaries, rent, and taxes, not directly related to a long-term contract, are deductible only in the year you paid or incurred them, depending on the method of accounting you otherwise use. These expenses may not, under any circumstances, be made part of the computations under the percentage of completion or the completed-contract methods.

**Change of method.** You may change to either the percentage of completion or completed-contract method of reporting income from long-term contracts only with the permission of the Internal Revenue Service. You will also have to use the method you chose for any other long-term contracts, unless you get permission from the Internal Revenue Service to change to another recognized method.

## Accounting Periods

Every taxpayer must figure taxable income and file a tax return on the basis of an annual accounting period called a tax year.

A tax year is usually 12 consecutive months. It may be a calendar year or a fiscal year (including a period of 52 or 53 weeks). Under certain conditions your tax year may be less than 12 months, but it may not be more than 12 months unless you use a 52-53 week year.

A calendar year is 12 consecutive months ending on December 31. A fiscal year is either 12 consecutive months ending on the last day of any month other than December, or a 52-53 week year. To report on a fiscal year basis, you must keep your books on that basis. See *A 52-53 week year,* later.

A short tax year is a tax year of less than 12 months. A short tax year return is treated as a return for a full tax year.

### Establishing the Tax Year

If you have never filed an income tax return before, you may adopt either a calendar or a fiscal year. The first tax year must be adopted by the set time set by law (not including extensions) for the filing of a return for that tax year.

**Sole proprietors.** You establish a tax year when you file your first income tax return. If in a later year you begin business as a sole proprietor, you must continue to use the same tax year unless you get permission to change. See *Changing Your Tax Year,* later. You must report your income from all sources, including your sole proprietorship, salaries, and dividends, on the basis of the same tax year.

**Fiscal year taxpayer.** Taxes withheld from your wages, as shown on your Form W-2, *Wage and Tax Statement,* are a credit against your income tax liability. If you are a fiscal year taxpayer, you would claim this credit for your fiscal year in which the calendar year covered by Form W-2 ends.

**Partners.** You must include in your income your distributive share of partnership items plus any guaranteed payments, including salary or interest, you received or accrued from the partnership for ***any partnership year ending within or with your tax year.***

***Example.*** You use the calendar year and your partnership uses a fiscal year ending June 30. You received guaranteed payments of $500 on October 11, 1979, and $500 on April 11, 1980. The entire $1,000 must be included on your income tax return for calendar year 1980, together with your distributive

share of partnership income for the partnership year ending on June 30, 1980.

**Tax year of partnership.** If the principal partners (those having an interest of 5% or more in partnership profits or capital) have different tax years, a newly formed partnership may adopt the calendar year without prior approval of the Internal Revenue Service. The newly formed partnership may also adopt the tax year of all its principal partners (or the tax year to which all the principal partners are changing) without prior approval. However, if the new partnership wishes to adopt any other tax year, it must first get the approval of the Internal Revenue Service.

***Special rules.*** If a partnership wants to adopt or change to an accounting period that is different from the accounting period of its principal partners, it should file a timely application, Form 1128, *Application for Change in Accounting Period*, with the Commissioner of Internal Revenue, Attention: T:C:C:1:2, Washington, D.C. 20224.

The Internal Revenue Service will consider all facts and circumstances including the federal income tax consequences, and any distortion of income that is caused by deferring the income. The request will usually be approved if the adoption or change will result in a deferment of income to the partners of 3 months or less. The Internal Revenue Service and the partnership also must agree to the terms under which the adoption or change will be accomplished.

Usually, one of the terms the Internal Revenue Service requires the partnership to agree to is that it will include an adjustment in income for the short tax year. The adjustment equals the excess of its income over its expenses for the 3 months following the short tax year. One-tenth of the adjustment is deducted from the partnership income for the short tax year and one-tenth is deducted from the partnership income in each of the nine following tax years. If expenses are more than income for the 3-month period, no adjustment is required.

***A partnership that changes its tax year*** should make its return for a short period, but should not report its income on an annual basis. The partnership attaches to the return either a copy of the letter from the Commissioner granting permission to change, or a statement that the partnership is changing its tax year to the tax year of all its principal partners or the tax year to which all its principal partners are changing.

***Continuation of partnership year.*** Usually a partnership's tax year continues after the death of a partner, the entry of a new partner, or the liquidation, sale, or exchange of a partner's interest unless there is a termination of the partnership.

**Corporations.** A new corporation establishes its tax year when it files its first tax return. For example, the filing of a calendar year return or short tax year return ending on December 31 establishes a calendar tax year. The first tax year may not extend beyond the 12th month of corporate existence (unless a 52-53 week year is elected). The return is due by the 15th day of the 3rd month following the end of the tax year, if the time for filing has not been extended.

***A newly reactivated corporation,*** which has been inactive for a number of years, is treated as a new taxpayer for the purpose of adopting a tax year.

**A 52-53 week year** may be used as the tax year if you keep your books on that basis. This is a fiscal year that:

1) Varies from 52 to 53 weeks; and
2) Ends always on the same day of the week; and
3) Ends as of the date that day last falls in a particular calendar month or the date it falls nearest the end of a particular calendar month.

For example, if you elect a tax year ending always on the last Wednesday in March, then for the tax year 1981, your tax year will end on March 25, 1981. If you elected a tax year ending always on the Wednesday nearest to the end of March, then for the tax year 1981, your tax year will end on April 1, 1981.

***You make the election*** by filing your tax return for the 52-53 week year and attaching to it a statement showing:

1) The day of the week on which the tax year will always end; and
2) Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month; and
3) The month in which or with reference to which the tax year will end.

***When you figure depreciation*** or amortization, a 52-53 week year is considered a year of 12 full months, unless you have consistently used some other practice in the past.

***To find the due dates of returns*** or the effective dates of other provisions of the law that are expressed in terms of tax years beginning or ending with reference to the first or last day of the specified calendar month, a 52-53 week year is considered to begin on the first day of the calendar month nearest to the first day of the 52-53 week year. The 52-53 week year is considered to end on the last day of the calendar month ending nearest to the last day of the 52-53 week year. For individuals, the due date for filing a return is the 15th day of the 4th month after the close of the tax year, and for a corporation, the due date is the 15th day of the 3rd month after the close of the tax year.

***Example 1.*** A corporation uses a 52-53 week year that ends on the last Wednesday in March. For the year ended March 25, 1981, it is required to file Form 1120 by June 15, 1981. If its year ended on the Wednesday nearest to the end of March, it would not end until April 1, 1981, but Form 1120 still would be due by June 15, 1981. In both cases, the year is considered to end on March 31, 1981.

***Example 2.*** Assume that an income tax provision applies to tax years beginning on or after January 1, 1981. For that purpose, a 52-53 week tax year beginning on any day within the period of December 26, 1980, to January 4, 1981, inclusive, will be treated as beginning on January 1, 1981.

## Changing Your Tax Year

You must, with certain exceptions, get the approval of the Commissioner of Internal Revenue to change your tax year by filing Form 1128. This form must be filed by the 15th day of the second calendar month after the close of the short tax year. This short tax year begins on the first day after the end of your present tax year and ends on the day before the opening date of your new tax year. File the form in triplicate with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention T:C:C:1:2.

In some cases it may be possible to get a extension of time to change your tax year. See the earlier discussion under *Extensions of time to secure consent*.

Your application must contain all of the information requested. It should show that there is a substantial business purpose for the change and that any tax advantage resulting from it will not be significant. Do not change your tax year until the Commissioner has approved your request.

If your application is approved you must file an income tax return for the short period. There are special rules for figuring the tax for a short tax year caused by a change in your tax year. See *Figuring the tax*, later.

**An existing partnership** must get the approval of the Commissioner before it can change its tax year, unless the change is to the tax year of all the principal partners, or to the tax year to which all the principal partners are changing at the same time.

***Change in partner's year.*** You as a partner may change your tax only if you first get approval of the Commissioner.

**A corporation** (other than a Subchapter S Corporation or a DISC) may change its annual accounting period without first getting the approval of the Commissioner if the following conditions are met:

1) It must not have changed its tax year within the 10-calendar years ending with the calendar year in which the short period resulting from the change begins; and
2) Its short period must not be a tax year in which it has a net operating loss; and
3) Its taxable income for the short period must be (when annualized) 80% or more of its taxable income for the tax year before the short period; and
4) If it is a personal holding company, foreign personal holding company, exempt organization, foreign corporation not engeged in trade or business within the United States, or Western Hemisphere trade corporation, ***either*** for the short period or for the pre-

ceding tax year, it must have the same status for ***both*** the short period and the tax year before; and

5) It must not try to make an election as a Subchapter S corporation for the tax year that would immediately follow the short period required to effect the change.

A statement on behalf of the corporation must be filed with the Internal Revenue Service office where the corporation files its tax returns by the time for filing its return for the short period required by the change.

The statement must indicate that the corporation is changing its annual accounting period under section 1.442-1(c) of the Income Tax regulations and must show that all the preceding conditions have been met. If, on examination, the corporation does not meet all the conditions because of later adjustments in establishing tax liability, the statement will be considered a timely application for permission to change the corporation's annual accounting period to the tax year indicated in the statement.

A Subchapter S corporation or a DISC may not change its annual accounting period without first getting the approval of the Commissioner.

If your records are not adequate or you have an accounting period that does not meet the requirements for a fiscal year, your tax year is the calendar year. In this case, if you adopt a fiscal year it will be treated as a change in your annual accounting period and you will have to first get the approval of the Commissioner.

**You may change to a 52-53 week year** that ends with reference to the end of the ***same month*** with which your present tax year ends, without first getting the permission of the Commissioner.

***Example.*** If you now use a calendar year and want to change to a 52-53 week year ending on the Thursday closest to December 31, prior approval is not needed. You make the election to change when prior approval is not required by filing the statement described previously under *A 52-53 week year* with your return.

***Approval required.*** If you change to a 52-53 week tax year that ends with reference to the end of a month that is ***not the same month*** in which your old tax year ended, you must first get the approval of the Commissioner, as explained previously.

***Example.*** If you use a calendar year and want to change to a 52-53 week year ending on the Saturday nearest the end of November, you must first get the approval of the Commissioner.

***To change from a 52-53 week year*** to any other tax year, including another 52-53 week year, you must first get the approval of the Commissioner. See *Changing Your Tax Year*, previously discussed.

**Husband and wife.** The following rules apply to a spouse wanting to change his or her accounting period to that of the other spouse so they may file a joint tax return.

***Newlyweds.*** A newly married wife or husband may adopt the accounting period of the other spouse without first getting approval. They may file a joint return for the first tax year ending after the date of marriage if:

1) The due date for filing the required separate short period return of the spouse wishing to change (the 15th day of the 4th month following the end of the short period) falls on or after the date of the marriage; and

2) The return for the short period is timely filed.

If, on the date of the marriage, the due date for filing the required separate return has passed, the couple may not file a joint return until the second tax year ending after the date of the marriage, and then only if the spouse who is changing the tax year files a timely short tax year return. The short tax year return must include a statement that the accounting period is being changed under authority of section 1.442-1(e) of the Income Tax regulations.

***Example 1.*** John and Jane were married on July 31, 1980. John filed his return for the fiscal year ending June 30. Jane uses the calendar year, but wants to change to John's fiscal year so they may file a joint return. If Jane files a separate return by October 15, 1980, for the short period January 1 through June 30, 1980, she will have changed her accounting period to a fiscal year ending June 30. Then she and John may file a joint return for their tax year ending June 30, 1981.

***Example 2.*** If John and Jane were not married until October 17, 1980 (one day after the last day Jane could file a timely short period return for the first year of their marriage), they must file separate returns for the first tax year ending after the date of their marriage. If Jane files a timely separate return for the short period January 1 through June 30, 1981, they may file a joint return for their tax year ending June 30, 1982, and for future years.

***Any other husband or wife*** wishing to change to the accounting period of the other spouse so that they may file a joint return must first get the permission of the Commissioner of Internal Revenue. Permission may be granted even if there is no substantial business purpose for requesting the change.

## Short Tax Year

A tax return is required for the period of time a taxpayer is in existence, even if not for a full tax year. In general, the return in this case is considered to be for a full tax year. Therefore, income for the period covered does ***not*** have to be ***annualized*** (put on an annual basis), as in the case of a short tax year caused by a change in tax year, described later. This rule also applies to a subsidiary joining a consolidated group.

Requirements for filing the return and paying the tax are generally the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

***Example 1.*** A new corporation that came into existence on July 2, 1980, and elected the calendar year as its tax year must file its return by March 16, 1981 (the first working day after March 15, 1981). The return covers the period July 2, 1980, to December 31, 1980.

***Example 2.*** A calendar year corporation that dissolved on July 27, 1981, must file its final return by October 15, 1981, for the period January 1 to July 27, 1981.

***Example 3.*** A new partnership formed on September 12, 1980, is required to file its return by April 15, 1981, if all of its principal partners use a calendar year, or it receives permission to use the calendar year.

**If an individual dies,** a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year.

***Example.*** Agnes Jones was a calendar year taxpayer. She died on March 6, 1980. Her last tax return for the period January 1 — March 6, 1980, must be filed by April 15, 1981.

**Figuring the tax.** If the Commissioner approves the change in your tax year, you must figure the tax and file your return for the short tax year that begins with the first day after the end of your old tax year and ends on the day before the first day of your new tax year.

Corporation returns are due by the 15th day of the third month after the short tax year. Other taxpayers must file the return by the 15th day of the fourth month after the short tax year.

***Example.*** If you have used the calendar year and get permission to use the fiscal year ending November 30, you must file a return for the short tax year beginning January 1 and ending November 30. If your business is a corporation, that return is due by February 15. For individuals and partnerships the return for the short tax year is due by March 15.

If the 15th day of the month falls on a Saturday, Sunday or legal holiday, the due date is the next business day.

***The tax for the short tax year*** is figured under a general rule. Then with one exception, after one year from the beginning of the short tax year, there is a relief procedure available under which you may be able to claim a refund of some of the tax you paid under the general rule. The general rule, the relief procedure, and the exception are explained later.

**General rule.** Figure the income tax for the short tax year by placing its taxable income on an annual basis. Self-employment tax is figured on actual self-employment income. It is never annualized.

***Individuals*** figure their income tax for the short tax year under the general rule as follows:

1) Determine the adjusted gross income for the short tax year and subtract the actual amount of itemized deductions for the short tax year. You must itemize your deductions when you file a short tax year return; and
2) Multiply the total amount of the personal exemption and the exemptions for dependents by a fraction. The numerator (top part) is the number of months in the short tax year and the denominator (bottom part) is 12; and
3) Subtract the amount in (2) from the amount in (1) (modified taxable income); and
4) Multiply the difference determined in (3) by 12 and divide by the number of months in the short tax year; and
5) Add the zero bracket amount to the amount in (4) (annualized income); and
6) Figure the total tax on the amount in (5) (use the tax rate schedules); and
7) Multiply the amount in (6) by the number of months in the short tax year and divide by 12.

***Example.*** Frank Jones has an adjusted gross income of $18,150. His itemized deductions total $4,200, and he is entitled to exemptions for himself, his wife and two children. The income and the itemized deductions are for the 9-month period January 1 through September 30, 1980. He will figure his tax on a joint return for that period as follows:

1) $18,150 − $4,200 = $13,950
2) $1,000 × 4 × 9/12 = $3,000
3) $13,950 − $3,000 = $10,950 (modified taxable income)
4) $10,950 × 12/9 = $14,600
5) $3,400 (zero bracket amount) + $14,600 = $18,000 (annualized income)
6) Tax on $18,000 = $2,745 (use tax rate schedule)
7) $2,745 × 9/12 = $2,058.75 (tax for short tax year)

***Corporations*** figure the tax for the short tax year under the general rule described above for individuals. (There is no adjustment for personal exemptions or addition of the zero bracket amount.)

***Example.*** A corporation files a tax return, because of a change in its accounting period, for the 6-month short tax year ending June 30, 1980. It had taxable income of $40,000 during the short tax year. Its annualized taxable income is $80,000 ($40,000 × 12/6). Its tax liability is figured as follows:

| | |
|---|---|
| Graduated tax | |
| 17% of 1st $25,000 | $ 4,250 |
| 20% of 2nd $25,000 | 5,000 |
| 30% of 3rd $25,000 | 7,500 |
| 40% of $5,000 | 2,000 |
| Total tax (as annualized) | $18,750 |
| **Tax for short tax year** ($18,750 × 6/12) | $ 9,375 |

***52-53 week year.*** If you must first get approval because you change the month with reference to which the tax year ends, as explained before in *Changing Your Tax Year*, you must file a return for the short tax year if it covers more than 6 or less than 359 days. Periods of 6 days or less and 359 days or more are discussed later. Thus, if you use a calendar year and the Commissioner approves your election to change in 1981 to a 52-53 week year ending on the Tuesday closest to August 31, you must file a return for the short tax year from January 1, 1981 to September 1, 1981.

Tax for the short tax year is figured as shown previously, except that you annualize on a daily rather than a monthly basis. You use 365 instead of 12, and you use the number of days in the short tax year instead of the number of months. Use 365 days regardless of the number of days in the calendar year.

If you change to or from a 52-53 week year and the short period is 6 days or less or 359 days or more you do not annualize the income. A short period of 6 days or less is added to and treated as part of the tax year that follows the short period. A short period of 359 days or more is treated as a full tax year. Thus, if you make the election to change to a 52-53 week year without changing the month with reference to which the tax year ends, the income for the short period will never be annualized.

***Example 1.*** For years after 1979, you elect to change from the calendar year to a 52-53 week year ending on the Thursday nearest to December 31. Except for the rule applying to short periods of 6 days or less, your first 52-53 week tax year return would be filed for a short period of 3 days (January 1-3, 1980). Because of the special rule, however, these days are added to your tax year covering the period from Friday, January 4, 1980, to Thursday, January 1, 1981. Thus that tax year is considered to begin on January 1, 1980, and end on January 1, 1981.

***Example 2.*** For years after 1979, you elect to change from the calendar year to a 52-53 week year ending on the last Friday in December. You file a return for the tax year from January 1, 1980, to December 26, 1980, as you would for a regular tax year since the short period is more than 358 days. You file your next tax return for the period Saturday, December 27, 1980, to Friday, December 25, 1981.

**Relief procedure.** A relief procedure is available for figuring the tax for the short tax year. It may result in less tax. Under the relief procedure, the tax is figured by two methods. If both methods yield a tax amount that is less than the amount of tax that you figured for the short tax year under the general rule, you may file a claim for refund of some of the tax you paid under the general rule. Both individuals and corporations may use the relief procedure.

***To figure that tax under the first method*** you must wait until a 12-month period has passed since the first day of the short tax year. Then, you must figure your taxable income for the 12-month period and the tax on that income. You must also figure your modified taxable income for the 12-month period. Then you figure the tax under the first method by using a fraction. The numerator (top part) of the fraction is the modified taxable income for the short tax year as figured under the general rule previously. The denominator (bottom part) of the fraction is the taxable income of the 12-month period. Multiply this fraction by the tax for the 12-month period. The product is the tax as figured under the first method.

***Example.*** Suppose, in the previous example under *Individuals*, that Frank Jones for the 12-month period from January 1 to December 31 had adjusted gross income of $21,000, itemized deductions of $5,000, and is entitled to four exemptions. Thus his taxable income is $15,200 ($21,000 − ($5,200 + $4,000) + $3,400). He must figure the tax that would be due, just as if he were filing a return for the 12-month period. On a joint return the amount of the tax is $2,097.

His modified taxable income for the 12-month period is $11,800 ($15,200 − $3,400 (zero bracket amount)). The modified taxable income for the short tax year is $10,950 (see item (3) in the previous example).

He figures the tax under the first method by multiplying the tax for the 12-month period by a fraction. The fraction is the modified taxable income for the short tax year divided by the modified taxable income for the 12-month period ($10,950/$11,800). The tax under the first method is $1,945.94 ($2,097 × ($10,950/$11,800)).

***To figure the tax under the second method*** of the relief procedure, you must add the zero bracket amount to the modified taxable income for the short tax year and then figure the tax on that amount.

***Example.*** As a continuation of the example with Frank Jones, his taxable income for the short tax year plus the zero bracket amount is $14,350. His tax on a joint return on this amount is $1,918.50.

***Claim for refund.*** If the tax figured under the two methods of the relief procedure is less than the amount of tax that was reported and paid for the short tax year under the general rule, you may file a claim for refund for part of the tax that was reported and paid for the short tax year. The amount of the claim for refund is the difference between the amount of tax reported and paid for the short tax year under the general rule and the largest amount of tax figured under the two methods of the relief procedure. The claim for refund must be accompanied by a statement that shows the computation of the taxable income for the 12-month period and the computation of the tax under the first method of the relief procedure.

***Example.*** Frank Jones in the previous examples would file a claim for refund for $112.81. That is the difference between the amount of tax reported and paid under the

general rule ($2,058.75) and the largest tax figured under the two methods of the relief procedure ($1,945.95).

Along with his claim for refund he would include a statement that shows how he figured taxable income for the 12-month period and how he figured the tax for the first method of the relief procedure.

**Exception.** If a taxpayer is not in existence at the end of the 12-month period described above, or if the taxpayer is a corporation that has distributed substantially all of its assets before the end of the 12-month period, then the period to be used in the special method is the 12-month period ***ending*** with the last day of the short period.

If at the time the return for the short tax year is filed, it is known that the period to be used under the special method is the 12-month period ending with the last day of the short tax year, the tax for the short tax year may be determined under the special method at that time. In such case, the return for the short tax year should show the taxable income and computation of tax for the 12-month period together with the computation of the tax under the general rule. The return will then be considered an application for the benefits of the special method. The computations are the same as when the 12-month period beginning with the first day of the short tax year is used.

**Minimum tax.** There is a minimum tax on tax preference income items if these items are more than an exemption that is equal to the greater of $10,000 ($5,000 for a married person filing a separate return) or half the regular income tax liability for the tax year.

***To figure your exemption for a short tax year,*** multiply the $10,000 exemption by a fraction. The numerator (top part) is the number of days in your short tax year and the denominator (bottom part) is 365.

***Example.*** You have tax preference income of $40,000 for your short year of 292 days and half of your regular income tax is $7,500. You figure your exemption as follows:

| | |
|---|---|
| preference income | $40,000 |
| Exemption: | |
| $10,000 × 292 ÷ 365 | 8,000 |
| **Amount of tax preference income to be taxed** | $32,000 |

For more information on the minimum tax on tax preference income for individuals, see Publication 525, *Taxable and Nontaxable Income;* corporations can find a discussion in Publication 542.

**Alternative minimum tax.** For a taxpayer, other than a corporation, the alternative minimum taxable income for the short tax year is placed on an annual basis by multiplying it by 12 and dividing that product by the number of months in the short tax year. Use this annual alternative minimum taxable income to figure the annual alternative minimum tax. Figure the short tax year alternative minimum tax by multiplying the annual alternative minimum tax by the number of months in the short tax year and dividing the product by 12. See Publication 525 for a discussion of alternative minimum tax.

**Tax withheld on wages.** You are entitled to a credit against your tax liability for federal income taxes withheld from your wages. This withholding is always on a calendar year basis.

If you had more than one tax year begin in the same calendar year, the total amount withheld must be taken as a credit for the last tax year beginning in the calendar year.

## Excise Tax Periods

You must account for most federal excise taxes quarterly. Some excise taxes must be paid by July 1 each year, or on the date you become liable for them. The quarters covered, in most cases, are:

| Calendar quarter | Calendar months |
|---|---|
| First | January, February, March |
| Second | April, May, June |
| Third | July, August, September |
| Fourth | October, November, December |

## Employment Tax Periods

You must use the calendar quarter for withheld income tax and social security tax. You must use the calendar year for federal unemployment tax.

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